

COMMENT

SOLVING THE LATIN AMERICAN SOVEREIGN DEBT CRISIS

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1. INTRODUCTION

During the past two decades, many Latin American nations were dubbed “emerging nations” and were given loans to enable them to strengthen their economies. However, these nations have had difficulty repaying their sovereign debt. The loans granted by “developed” countries were sold to private creditors and restructured. In the past five years, several Latin American nations have taken steps to achieve financial stability and reign in their sovereign debt through bond swaps and restructuring. Other Latin American nations are teetering on the edge of default, and collaboration with creditors may be their only chance to avoid economic destruction. In some cases, however, creditors have refused to participate in restructuring programs, leading to litigation. There have been a series of cases in federal courts of the United States involving Latin American nations and their creditors. Many of these cases have taken place in the United States because they involve creditors from the United States and because the loans were organized under United States law. Nevertheless, the sovereign debt crisis has yet to be completely resolved in a manner that is acceptable to both creditors and sovereign borrowers.

Many solutions have been proposed to resolve the sovereign debt crisis in Latin America. To understand the crisis one must first understand the background leading up to the crisis as well as the steps that have already been taken to relieve the strain of debt on both the debtholders and the borrowers. Section 2 of this Comment sets out the history of loans to Latin America, leading up

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to the current debt crisis. Section 3 contains an analysis of the early steps taken to provide relief to sovereign debtors, including various restructuring plans and the securitization of the debt.

In Section 4 of this Comment, the most recent trends in debt restructuring are discussed. Additionally, this Section examines the problem of a nation on the verge of default and poses a possible solution. In Section 5, several representative cases brought by sovereign debt creditors in federal courts in the United States are summarized. This Comment only deals with cases brought within the jurisdiction of the United States because these cases are both typical of sovereign debt disputes and complementary to this Comment's analysis of the United States government's policy regarding the sovereign debt crisis. Section 6 analyzes the effect of litigation on the debt crisis and seeks to synthesize the United States government's policy on the crisis. Section 7 describes two proposed solutions to the continuing problem of holdout creditors who refuse to participate in restructuring and choose to litigate instead.

This Comment concludes, in Section 8, that in order to resolve the sovereign debt crisis in Latin America, steps must be taken to induce creditors to participate in voluntary restructuring plans, thereby allowing more time for debtor nations to rebuild themselves. In addition, there must be a means of limiting the incentives for creditors of sovereign nations to litigate.

2. HISTORY OF THE LATIN AMERICAN DEBT CRISIS

Following World War II, loans were extended to sovereign nations under the Bretton Woods System.¹ This system, created under the multinational Bretton Woods Agreement signed in 1944, devised the International Monetary Fund ("IMF"). This agency was designed to grant loans to countries in order to forestall economic recessions.² However, the amount of money lent to a particular nation was limited by the amount contributed by each member. In addition, it was possible for the IMF to condition lending based on a country's compliance with certain stipulations, designed to promote the nation's financial stability and independ-

¹ Theodore Allegaert, *Recalcitrant Creditors Against Debtor Nations, or How to Play Darts*, 6 MINN. J. GLOBAL TRADE 429, 433 (1997).

² Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2709 n.31 (1996).

ence.³ In spite of these restrictions, the Bretton Woods System was a major source of funding for loans to sovereigns through the 1960s.⁴ The IMF loans were simply intended as a band-aid, to tide nations over during short-term economic difficulties. They were used to avoid "the imposition of economic restraints which may adversely affect the economies of both the distressed country and of other nations."⁵ Indeed, the conditions placed on borrowing governments by the IMF were structured as a barrier against the use of economic restrictions as a mechanism for stabilizing the economy.

However, in the late 1960s and early 1970s, the Bretton Woods System started to crumble, in part because the contributions of member nations to the IMF did not increase at the same rate as inflation.⁶ For this reason, even though the IMF had more money, its purchasing power decreased sharply in relation to what it had previously been. Additionally, the IMF was no longer able to keep a check on the currency exchange rates between nations, which led to overvalued currencies and payment deficits.⁷

At the same time the Bretton Woods System began to disintegrate, the number of loans granted to sovereign nations by commercial banks increased dramatically. In the 1970s, financial institutions in the United States received huge sums of money deposited by wealthy oil-producing nations and were looking for new investment markets.⁸ Meanwhile, the market prices of Latin American exports increased during the first few years of the 1970s,

³ See Allegaert, *supra* note 1, at 433 (providing an overview of commercial lending to sovereign states); see also ANDREAS F. LOWENFELD, *THE INTERNATIONAL MONETARY SYSTEM* § 8.4 (2d ed. 1984) (quoting the testimony of Dr. Arthur Burns before the Joint Economic Committee on Feb. 23, 1977).

⁴ See Allegaert, *supra* note 1, at 433 ("For many years, the Bretton Woods System, with its emphasis on fixed exchange rates, worked tolerably well . . . [I]t provided a salutary check on LDCs' ever-increasing appetite for Western capital.").

⁵ Power, *supra* note 2, at 2709 n.31 (citing Jody D. Newman, *Exchange Controls and Foreign Loan Defaults: Force Majeure as an Alternative Defense*, 71 IOWA L. REV. 1499, 1509 n.89, 1510 n.92 (1986)).

⁶ Allegaert, *supra* note 1, at 434.

⁷ THE FUTURE OF THE INTERNATIONAL MONETARY SYSTEM 1-2 (Tamir Agmon et al. eds., 1984).

⁸ Samuel E. Goldman, Comment, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J. INT'L L. & FOREIGN AFF. 159, 165 (2000).

making Latin America seem like a solid target for investment.⁹ These less developed countries ("LDCs") looked to stabilize their economies and expand their growth, and found that the Western banks were more than willing to lend them money.¹⁰ This willingness to grant loans to sovereign nations further weakened the Bretton Woods System of the previous three decades. While the IMF conditioned borrowing on certain rigid prerequisites, the banks generally did not, making it easier for countries to get the assistance they desperately wanted. Asking the IMF for money became the less preferable loan option.¹¹ While private banks provided only a third of all financing to LDCs in 1973, the percentage rose to nearly half by 1976.¹² Over the next four years, private banks continued to provide a greater proportion of total loans to sovereign borrowers, jumping to seventy percent in 1980.¹³ According to Rory MacMillan, "[b]etween 1973 and 1983, Latin American external debt rose from about \$48 billion to about \$350 billion, amounting to 58% of the gross regional product."¹⁴

The Latin American debt crisis began in August 1982, when Mexico declared that it could no longer pay the principal on its foreign debt.¹⁵ Other Latin American nations, including Brazil, Venezuela, Argentina, and Bolivia, subsequently announced that they, too, were unable to service their foreign creditors.¹⁶ There were many factors that contributed to the defaults in loan payments, including the oil crisis of the late 1970s that led to higher oil prices. In order to pay for the amount of oil needed to keep their countries

⁹ See Alberto G. Santos, Note, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 72 (1991) (noting that "rising world prices for raw materials—particularly food, metal, and oil products exported by these countries—made many of the countries worthwhile credit risks.").

¹⁰ Goldman, *supra* note 8, at 165.

¹¹ See Allegaert, *supra* note 1, at 434 (explaining the reasons why sovereigns preferred to ask for loans from Western banks).

¹² Goldman, *supra* note 8, at 165-66.

¹³ Allegaert, *supra* note 1, at 435 (citing *A Nightmare of Debt: A Survey of International Banking*, ECONOMIST, Mar. 20, 1982, at 99).

¹⁴ Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 311 n.31 (1995) (citing PEDRO-PABLO KUCZYNSKI, LATIN AMERICAN DEBT 14 (1988)).

¹⁵ Ross P. Buckley, *The Transformative Potential of a Secondary Market: Emerging Markets Debt Trading From 1983 to 1989*, 21 FORDHAM INT'L L.J. 1152, 1152 (1998) [hereinafter Buckley, 1983 to 1989].

¹⁶ Power, *supra* note 2, at 2708.

functioning, governments were forced to borrow more money.¹⁷ Additionally, the United States raised its interest rates in 1981, causing debtor nations to have higher interest payments than they had anticipated.¹⁸ This combination of circumstances led many Latin American debtor states to default or nearly default on their loans.

3. EARLY STEPS TAKEN TO ALLEVIATE THE DEBT CRISIS

Following the announcement of the financial crisis in Latin America, a series of steps were taken to curtail the further economic collapse of the borrowing countries as well as the lending banks and institutions themselves. These methods included bridge loans, numerous restructurings, and the securitization of loans under the Brady Plan.

3.1. Bridge Loans

One of the first preventive measures taken by the commercial banks was the extension of bridge loans, which permitted countries to continue paying the interest on their loans, even though they were not able to pay the principal.¹⁹ Bridge loans were, in effect, new loans granted by the banks to allow sovereigns to pay the interest on their old loans. To ensure that no bank was paying a disproportionate share of the new loans, each bank was only responsible for contributing a specified percentage of its own outstanding loans to the debtor nation.²⁰

By permitting this form of transaction, the banks were protecting themselves. Because the borrowing nations had not completely defaulted on their payments, the banks could still declare the loans as assets on their balance sheets.²¹ Without this provision banks were required by regulatory and accounting rules to declare a loan "nonperforming"²² if interest payments were more than ninety days late, an unfavorable prospect from the bank's financial perspective. It was especially vital that banks kept borrower nations

¹⁷ *Id.* at 2707.

¹⁸ Goldman, *supra* note 8, at 166; see also Power, *supra* note 2, at 2707.

¹⁹ Goldman, *supra* note 8, at 166.

²⁰ See Lee C. Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 1988 U. ILL. L. REV. 401, 405 (1988).

²¹ Goldman, *supra* note 8, at 167.

²² Power, *supra* note 2, at 2710.

from defaulting on their loans because many of the large banks had loaned out more money than they actually had to lend. In fact, when the debt crisis began in 1982, the nine largest commercial banks had loaned 250% of their capital to sovereign debtors.²³ It was therefore imperative to the banks' own survival that the debtor nations continued to pay, at the very least, the interest on their loans. Thus, immediately following the announcement of the debt crisis, many large banks extended new loans in order to prevent complete default, in hopes of cutting their own losses.

3.2. Debt-Equity Swaps and Restructuring

While bridge loans allowed sovereign debtors to continue paying interest on their original loans, the banks also tried to reduce their exposure to the larger default, that on the principal of the loans. However, smaller banks, holding less of the sovereign debt, rid themselves of a larger percentage of their exposure to sovereign debt without having to extend new loans to pay off the old loans.²⁴ Instead, these banks participated in "debt-equity swaps," which involved the transfer of a loan held by one bank to another bank or to a third party in exchange for an equity investment in the debtor country.²⁵ However, since these substitutions were only possible for a small portion of the debt, it was a practice used more often by smaller banks.²⁶

Debt rescheduling provided another means of restructuring the loan principal following the sovereign debt crisis. Creditors rearranged payment schedules to give debtors more time before the payments became due.²⁷ Because the smaller banks were in a better position to reduce their exposure to Latin American debt, they were often reluctant to participate in the debt reschedulings necessary to keep the larger banks from folding in the event of sovereign

²³ *Id.* at 2710 n.40; see also MacMillan, *supra* note 14, at 327 n.117 (detailing exposure of large U.S. banks to risk via Latin American debt); Santos, *supra* note 9, at 82-83 (documenting the history of U.S. commercial bank debt exposure to developing countries).

²⁴ See Power, *supra* note 2, at 2711 (describing the smaller banks' perspective on extending new credit to debtor nations).

²⁵ Alfred J. Puchala, Jr., *Securitizing Third World Debt*, 1989 COLUM. BUS. L. REV. 137, 138-39 (1989); see also Buckley, 1983 to 1989, *supra* note 15, at 1152.

²⁶ Goldman, *supra* note 8, at 167.

²⁷ See Robert Kenneth MacCallum, *Sovereign Debt Restructuring: The Rights and Duties of Commercial Banks Inter Sese*, 1987 COLUM. BUS. L. REV. 425, 430 (1987) (clarifying the difference between rescheduling and refinancing).

loan default. This caused a great deal of tension between the large and small banks, as the large banks had no choice but to restructure the loans, while the small banks were more capable of surviving in the event of default. It was necessary for all, or substantially all, of the creditors to work together in restructuring the loans,²⁸ but the small banks did not have any incentive to do so. "By refusing to lend new money to a debtor country, a less exposed bank could maintain its existing exposure to the country with the assurance that the more exposed banks would not permit the country to default on interest payments."²⁹ In order to eliminate this problem, steps were taken to pressure unwilling creditors into taking part in the loan restructuring.

The first stage in a rescheduling plan was usually to create a steering committee,³⁰ called a Bank Advisory Committee ("BAC"), comprised of twelve to fourteen of the largest bank creditors.³¹ The BAC served as a liaison among the creditors and was charged with representing all of their interests. The advisory committee was also responsible for direct negotiations with the debtor country.³² While the BAC was not officially able to impose restructuring terms on smaller creditors, it was often in the creditors' best interest to accept the terms negotiated by the BAC. As it was directly involved both with the creditors and with the sovereign debtors, the advisory committee was in the best position to glean information about the debtors' intentions regarding repayment. Therefore, in practice, the smaller creditors generally accepted the restructuring terms designated by the advisory committees, which often included the extension of bridge loans in order to prevent total default by debtors.³³

In addition, a typical restructuring included the extension of additional loans by the IMF. However, the IMF often refused to

²⁸ See Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. ILL. L. REV. 493, 494 (1988) (arguing that "the sovereign debt restructuring process has forced the international banking community into an uneasy confederation.").

²⁹ Power, *supra* note 2, at 2711.

³⁰ Ross P. Buckley, *Rescheduling as the Groundwork for Secondary Markets in Sovereign Debt*, 26 DENV. J. INT'L L. POL'Y 299, 300 (1998) [hereinafter Buckley, *Rescheduling*].

³¹ Goldman, *supra* note 8, at 167.

³² Power, *supra* note 2, at 2712.

³³ *Id.* at 2712 n.48 (discussing the practical implications of the BAC with respect to the smaller creditors).

grant loans unless the sovereign debtors agreed to follow a "structural adjustment program."³⁴ These programs called for economic austerity,³⁵ in order to improve the financial climate within debtor nations so that they eventually could repay their loans.³⁶

3.2.1. *The Effects of the Restructuring*

The restructuring and rescheduling of debt in this form continued throughout the 1980s, and some countries went through this process more than once.³⁷ "Eleven countries, including Argentina and Mexico, restructured their debt 10 or more times."³⁸ Many believed that rescheduling was the solution to the sovereign debt crisis and that time would, essentially, heal all wounds.³⁹ While in some respects this was true for the commercial banks, rescheduling had the opposite effect on the debtor nations and their citizens.

The extension of "new loans" to the sovereign debtors allowed them to keep paying interest on their bank loans, which enabled the banks to regain some of their financial stability.⁴⁰ However, as time passed, the conditions faced by the people living in the borrower nations only deteriorated. In order to continue meeting their schedules for paying interest, sovereign debtors were forced to take out more loans, putting them even further into debt. In spite of the austerity programs put into place by the IMF as a precondition for the new loans, many countries were unable to meet their payment obligations when the maturity dates for the rescheduled loans arrived.⁴¹ In addition, the per capita gross domestic product in Latin America declined throughout the 1980s.⁴² Unemployment

³⁴ Buckley, *Rescheduling*, *supra* note 30, at 301.

³⁵ *Id.* at 301 n.11 (explaining the reasons why the IMF, and not the commercial banks, stepped into the role of economic overseer).

³⁶ Power, *supra* note 2, at 2712.

³⁷ Allegaert, *supra* note 1, at 436 ("In the wake of the Latin American debt crisis came a series of restructurings of the sovereign debts of developing countries, followed in many cases by restructurings of the restructurings . . .").

³⁸ Power, *supra* note 2, at 2713 n.62.

³⁹ See Robert A. Pastor, *The Debt Crisis: A Financial or a Development Problem?*, in *LATIN AMERICAN DEBT CRISIS: ADJUSTING TO THE PAST OR PLANNING FOR THE FUTURE?* 5, 11 (Robert Pastor ed., 1987) (discussing the debate over whether rescheduling would end the debt crisis).

⁴⁰ Buckley, *Rescheduling*, *supra* note 30, at 303.

⁴¹ Power, *supra* note 24, at 2713 n.61.

⁴² See Jesús Silva-Herzog, *The Costs for Latin America's Development*, in *LATIN AMERICAN DEBT CRISIS: ADJUSTING TO THE PAST OF PLANNING FOR THE FUTURE?* 33, 35

levels skyrocketed, and “[by] 1993, 60 million more Latin Americans had been driven below the poverty line, bringing the total to nearly half of the population.”⁴³ Hundreds of people died in Venezuela while protesting the severity of the austerity programs imposed by the government on behalf of the nation’s creditors.⁴⁴ While the Western banks were able to recoup their losses to some extent, it came at a terrible cost to the borrowing nations.

3.3. *The Brady Plan: The Securitization of Sovereign Debt*

It soon became clear that the repeated restructuring of sovereign debt in Latin America was not working as well as had been hoped. The borrowing countries became even further embroiled in debt, with no means of extricating themselves, and their people were suffering from its effects. The banks continued treating the loans as performing assets because they received interest payments, but there was no hope that the principal would be paid on the loans at any time in the foreseeable future. In addition, in order for loan restructuring to actually take place, there had to be collaboration between the advisory committees, the smaller creditors, the IMF, and the debtor state—and each faction wanted concessions from the others.⁴⁵ There was clearly a need for a new approach to resolve the sovereign debt crisis.

In 1989, Nicholas Brady, who was the United States Secretary of the Treasury at the time, announced a scheme designed to “encourage banks voluntarily to reduce the debt burdens of LDC debtors.”⁴⁶ The proposal recognized that drastic measures, including partial debt forgiveness, were necessary in order to set the Latin American nations back on their own feet.⁴⁷ The Brady Plan (“Brady”), as it came to be known, called for the securitization of

(Robert Pastor ed., 1987) (tracing the difficulties Latin American countries had finding resources to aid with the burdensome debts in the 1980’s).

⁴³ Duncan Green, *Hidden Fist Hits the Buffers*, NEW INTERNATIONALIST, Oct. 1995, at 35.

⁴⁴ Walter Mossberg & Peter Truell, *Another Round: Bush Aides are Likely to Offer a Plan Soon on Third World Debt*, WALL ST. J., Mar. 9, 1989, at A1.

⁴⁵ See Power, *supra* note 2, at 2712-13 (demonstrating the ways in which each group was both dependent on the others and trying to manipulate them, with the result that “action was taken either collectively or not at all.”).

⁴⁶ *Id.* at 2720.

⁴⁷ See Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 FORDHAM INT’L L.J. 1802, 1804 (1998) [hereinafter Buckley, 1989 to 1993] (introducing the beginnings of the Brady Plan).

the loans owed by sovereign debtors. The loans were converted into bonds backed by U.S. Treasury Bonds and offered to the general public. The money generated by the sale of the bonds was then used to pay off the country's debt.⁴⁸

Under this arrangement, the banks no longer worried that they would collapse if a debtor state was forced to default on its loans, and the sovereign nations were absolved of the debt owed to the banks. Instead, the investors who had purchased the bonds periodically received payments that were dispersed through a fund set up for this purpose.⁴⁹ Sovereign debtors also benefited in other ways by Brady Plan securitizations. Brady Bonds issued at a discount from the original loans, thereby reducing the debtor's obligations. Additionally, they had a longer maturity date before payments were due,⁵⁰ which allowed sovereigns more time to generate revenue and rebuild their economies.

The Brady Plan also enabled individual investors to participate in and profit from the sovereign debt market.⁵¹ Since participation in a Brady restructuring was voluntary,⁵² creditors had the option of holding on to their portion of the debt. In addition, for those who chose to invest in Brady bonds, many contained "exit covenants," in which sovereign debtors waived their rights to request a restructuring of the bonds. If the agreement was violated, it was considered a default.⁵³ This provided some security for the investors. It was also possible for investors to trade or sell their bonds. Under the Brady Plan, there were many more investors, each holding a smaller piece of the debt, which allowed for greater flexibility than the pre-Brady market did.

Since the Brady Plan was introduced less than eleven years ago, many Latin American sovereigns have converted their bank loans to Brady bonds. These nations include Mexico, Costa Rica, Venezuela, Argentina, Brazil, and Peru. Until very recently, most of the outstanding sovereign debt was held in the form of Brady

⁴⁸ Power, *supra* note 2, at 2720.

⁴⁹ Puchala, *supra* note 25, at 137-38.

⁵⁰ Power, *supra* note 2, at 2721.

⁵¹ Goldman, *supra* note 8, at 168.

⁵² Buckley, 1989 to 1993, *supra* note 47, at 1804.

⁵³ See Lee C. Buchheit, *The Evolution of Debt Restructuring Techniques*, INT'L FIN. L. REV., Aug. 1992, at 12.

bonds.⁵⁴

4. THE CURRENT SITUATION AND ITS POSSIBLE EFFECTS

In the past few years, however, many Latin American sovereign debtors exchanged their Brady debt for global bonds or other types of debt.⁵⁵ Mexico led the way in 1996 when it exchanged \$1.75 billion in Brady bonds for a thirty-year global bond.⁵⁶ As of June 2001, the amount of Latin American sovereign debt held in the form of Brady bonds decreased from \$129 billion to \$63.5 billion.⁵⁷

4.1. *Theory Behind Exchanging Brady Bonds*

Latin American governments look more favorably upon the idea of exchanging their Brady debt for several reasons. Many Brady bonds are backed by United States Treasury zero coupon bonds, which act as collateral or as a guarantee and give investors greater security.⁵⁸ A country's ability to exchange collateralized bonds for uncollateralized bonds is therefore indicative of its strength. Investors are more wary of and shy away from collateralized bonds because they represent a much greater risk.⁵⁹ Financiers feel that their investments are safer if the purchased bonds are not supported by credit enhancements, such as Treasury bonds, and are therefore more reluctant to invest in bonds that are sup-

⁵⁴ Power, *supra* note 2, at 2722-23; see also BURAFF PUBLICATIONS, INTERNATIONAL SECURITIES REGULATION REPORT, June 8, 1995 (stating that "Brady Bond trading in 1994 was nearly seven times that of loan trading.").

⁵⁵ Many Latin American nations have begun swapping Brady debt with euro and Samurai markets, as well as with dollar-based global bonds. See, e.g., Joshua Chaffin & Arkady Ostrovsky, *International Capital Markets: Mexico Highlights Demise of the Brady*, FIN. TIMES (London), Mar. 27, 2001, at 36 (noting the welcome shrinking of the Brady bond market).

⁵⁶ Maria O'Brien, *Queens of the Curve*, LATINFINANCE, June 2001, at 22 [hereinafter O'Brien, *Queens*].

⁵⁷ See *id.* (listing the Merrill Lynch figures for Brady debt in Argentina, Mexico, and Brazil); cf. Chaffin & Ostrovsky, *supra* note 55, at 36 (stating that according to the International Institute of Finance, the amount of outstanding Brady bonds decreased from "\$121.4 billion in 1998 to \$83.5 billion at the end of 2000.").

⁵⁸ Chaffin & Ostrovsky, *supra* note 55, at 36; O'Brien, *Queens*, *supra* note 56, at 17.

⁵⁹ See Chaffin & Ostrovsky, *supra* note 55, at 36 ("[B]y swapping out of Brady bonds, countries in the emerging markets universe were also getting rid of a stigma attached to any restructure debt").

ported by such credit enhancements. Releasing the collateral also frees up money that would normally be used to secure the guarantees, allowing Latin American governments to put it to more productive uses.⁶⁰

In addition, asking investors to replace their Brady holdings with global bonds or other forms of long-term debt permits indebted sovereigns to extend the amount of time before the bonds reach maturity. This buys the sovereigns more time before paying off the bondholders.⁶¹ In this way, nations, ideally, are able to strengthen their economies before their debts mature.

Daniel Gleizer, the international director at Brazil's central bank, sums up debt exchanges by saying, "The cute thing about [debt exchanges] is that they have the ability to meet a lot of objectives simultaneously, set the benchmark for the private sector, smooth out the profile of the debt and achieve net present value savings with one transaction."⁶² The fact that Latin American governments can take such large steps towards financial stability through an exchange of Brady bonds shows they made significant progress. Nicholas Brady, who created the Brady bond and is now the chairman of Darby Overseas Investments, is quoted as saying that Brady bond exchanges "represent the end of a transition decade—a decade when many emerging market countries moved from debt restructuring to a fuller participation in the global economy."⁶³ In fact, he believes the decrease in the number of outstanding Brady bonds is a sign of their success;⁶⁴ it means that the Latin American economies are beginning to stand on their own.

⁶⁰ *Id.*; O'Brien, *Queens*, *supra* note 56, at 17.

⁶¹ See *Argentina-Debt Argentine Government Announces Bond-Swap*, EFE NEWS SERVICE, May 5, 2001 (discussing how a debt swap would replace bonds with four-year maturities with bonds maturing in seven to thirty years); John Barham, *Shedding its Burden*, LATINFINANCE, June 2001, at 26; *Brasil Emite \$5 bi e Alonga Divida Externa (Brazil Sells \$5bn of Bonds and Extends Foreign Debt Payment over a Longer Period)*, O GLOBO, Aug. 11, 2000 ("[T]he government managed to extend its debt payment by an average of 32 years by replacing Brady bonds with an average length to maturity of almost 8 years."); O'Brien, *Queens*, *supra* note 56, at 17; Maria O'Brien, *Ready to Rehabilitate Argentina*, LATINFINANCE, Mar. 1, 2001, at 89 [hereinafter O'Brien, *Rehabilitate*]; Jennifer L. Rich, *Latin American Markets Show a Glimmer of Hope*, N.Y. TIMES, June 5, 2001, § W, at 1; *Argentina to Follow Brazil's Steps and Issue Debt*, GAZETA MERCANTIL ONLINE, Jan. 9, 2001, available at LEXIS, News Library, Major World Publications File.

⁶² O'Brien, *Queens*, *supra* note 56, at 18.

⁶³ Chaffin & Ostrovsky, *supra* note 55, at 36.

⁶⁴ *Id.*

However, as the following example illustrates, Mr. Brady's optimism might be a bit premature.

4.2. Argentina: An Ongoing Example

Argentina, the second-largest country in South America,⁶⁵ is responsible for paying back a large proportion of Latin America's sovereign debt, estimated at between \$123 billion and \$130 billion.⁶⁶ However, for the past three years, Argentina has been suffering a recession.⁶⁷ In fact, Argentina's sovereign debt as a proportion of gross domestic product has doubled since 1992.⁶⁸ Additionally, the economy contracted and unemployment increased in the past two years.⁶⁹ Furthermore, the government of Fernando de la Rúa has not been successful in its attempts to slow the recession. Two economic ministers, José Luis Machinea and Ricardo Lopez Murphy, resigned in March 2001 after they failed to "mobilize sufficient political support for implementation of tough fiscal austerity measures, designed to bring the federal budget back

⁶⁵ CIA *Factbook—Argentina*, at <http://www.odci.gov/cia/publications/factbook/geos/ar.html> (last visited Sept. 10, 2001).

⁶⁶ *Latin America Sovereign Debt Market and Credit Ratings*, LATINFINANCE, Dec. 2000, at 12 [hereinafter *Sovereign Debt Market*]; Daniel Merolla, *Financial Pages, Argentina's Risk Premium Soars Amid Popular Strikes, Speculative Attacks*, AGENCE FRANCE PRESSE, Aug. 2, 2001, at 2; O'Brien, *Queens*, *supra* note 56, at 17; David Plumb, *Investors Fear Default Close for Argentina: US \$130-billion in Debt*, NAT'L POST (formerly FIN. POST), Aug. 2, 2001, at C10; David Roche, *Opinion, Latin American Economies on the Brink*, INT'L HERALD TRIB., June 23, 2001, at 8; Jonathan Wheatley, *Trying to Dance Away from Default*, BUS. WK., July 30, 2001, at 78.

⁶⁷ See, e.g., *Argentine Lawmakers Debate Giving Government Special Powers*, AGENCE FRANCE PRESSE, Mar. 26, 2001, at 1 [hereinafter *Argentine Lawmakers*] (announcing contemplation of special powers for Argentina's government); Barham, *supra* note 61, at 26 (explaining that Argentina was in the longest was in the longest recession in its history at the time of the article); Daniel Kruger, *Riding Out the Russias*, FORBES, June 11, 2001, at 208 (emphasizing the need for patience of investors during Argentina's recession); Mitchell Martin, *Argentina's Economic Plight Deepens; Cancellation of Debt Sale Undermines Confidence in Emerging Markets*, INT'L HERALD TRIB., Apr. 24, 2001, at 1 (describing an increase in investor's concerns about likelihood of default by Argentina); O'Brien, *Rehabilitate*, *supra* note 61, at 89; Robert Taylor, *Cavallo's Second Coming: Robert Taylor Reports on Domingo Cavallo's Return to the Political Fray in Recession-Wracked Argentina*, BANKER, May 9, 2001 (commenting on the expectations accompanying Argentina's new cabinet member).

⁶⁸ Barham, *supra* note 61, at 26; see also *Sovereign Debt Market*, *supra* note 66, at 12 (stating that Argentina's debt is likely to grow because the government will probably spend more than it raises in taxes and that it is likely to grow relative to the overall economy).

⁶⁹ *Argentine Lawmakers*, *supra* note 67, at 1.

in line with 2001 targets in Argentina's IMF programme."⁷⁰

Upon their resignation, Domingo Cavallo, who held the position of economic minister in Carlos Menem's cabinet a decade ago, returned to the position, in hopes that he was able to bring an end to Argentina's recession.⁷¹ During his first term, Cavallo instituted a system which pegged the Argentine peso in a one-to-one ratio with the United States' dollar.⁷² That system is currently place and, until recently, it was highly successful at curbing inflation.

In December 2000, the IMF loaned approximately \$40 billion to Argentina in order to prevent the government from defaulting on its debts.⁷³ Argentina also undertook several debt swaps since the beginning of 2001 in an effort to extend payment dates and to stabilize the economy. The largest and most promising of these, which took place in early June, succeeded in exchanging nearly \$30 billion in short-term debt for bonds with longer-term maturities.⁷⁴ Most recently, on August 1, 2001, the Argentine government agreed to swap \$1.3 billion of Treasury bills in order to push back its repayment obligations.⁷⁵

Unfortunately, nothing, including the bond swaps and the one-to-one dollar currency peg, was successful enough to stabilize Argentina's economy and bring it out of the three-year recession. In an effort to end the recession and return Argentina to economic health, Cavallo, the original proponent of the currency peg, announced plans to dilute the currency basket by including the euro. This would effectively end the peg to the dollar.⁷⁶

Other remedies are also being tried in order to put Argentina back on track so that it will not default on its sovereign loans. Cavallo also introduced a seven percent peso devaluation for ex-

⁷⁰ Taylor, *supra* note 67, at 903.

⁷¹ *Id.*

⁷² Martin, *supra* note 67, at 1; Roche, *supra* note 66, at 8; *Sovereign Debt Market*, *supra* note 66, at 12. Under this pegging system, Argentina's "central bank is required to hold one US dollar for each peso it issues, although it does not have enough hard currency to cover its total liabilities" *Sovereign Debt Market*, *supra* note 66, at 13.

⁷³ *Argentine Lawmakers*, *supra* note 67, at 1; O'Brien, *Rehabilitate*, *supra* note 61, at 89; Taylor, *supra* note 67, at 903.

⁷⁴ Rich, *supra* note 61, at 1; Wheatley, *supra* note 66, at 78.

⁷⁵ *Argentina Wants US \$8bn in Loans to Protect Currency*, GAZETA MERCANTIL ONLINE, Aug. 1, 2001, at 1, available at LEXIS, News Library, Major World Publications File; Plumb, *supra* note 66, at C10.

⁷⁶ Martin, *supra* note 67, at 1; Roche, *supra* note 66, at 8.

porters.⁷⁷ In addition, the government recently approved several austerity programs designed to keep Argentina on its payment schedule. On July 11, 2001, President Fernando de la Rúa announced a "zero deficit policy," meaning that the government will spend only what it collects in taxes.⁷⁸ The plan, approved by the Argentine Senate late in July, caused hundreds to demonstrate in protest of the severe pay cuts that came along with it.⁷⁹

4.2.1. *The End Result: Should Argentina Default?*

If the situation in Argentina does not improve in the next few months, Argentina will have no choice but to default. While there is strong incentive for the government to continue making its payments on time, default might not necessarily be such a bad option.

In August 2000, Ecuador became the first nation to default on its \$6.65 billion sovereign debt, resulting in a forced restructuring of the old bonds.⁸⁰ The exchange of the old debt for new erased forty percent of the principal and put Ecuador on a strict IMF program to regain economic stability.⁸¹ In the year since the regimen was instituted, Ecuador's economy slowly improved.⁸²

Although it is too early to predict how soon Ecuador will return to economic health, the preliminary success of the August 2000 restructuring may be a sign that perhaps default, or a partial default, might not be the worst option for Argentina. Some of the existing debt would be cancelled, and while it would probably mean a return to collateralized Brady bonds, that might be just what Argentina needs to get itself back on track. In addition, restructuring buys more time, as the new bonds could have longer maturity dates. Interest rates would be raised, in order to appease investors, but in the long run, Argentina's financial self-sufficiency

⁷⁷ Roche, *supra* note 66, at 8.

⁷⁸ See Daniel Helft, *Argentina's Debt Problems Expected to Spill Over*, INDUSTRY STANDARD, at <http://www.thestandard.com/article/0,1902,27897,00.html> (last visited Sept. 17, 2001); Merolla, *supra* note 66, at 1; *Vote Draws Protests, Market Approval in Argentina*, AGENCE FRANCE PRESSE, July 30, 2001, at 1-2 [hereinafter *Vote Draws Protests*].

⁷⁹ Merolla, *supra* note 66, at 2; *Vote Draws Protests*, *supra* note 78, at 1.

⁸⁰ Deepak Gopinath, *Putting Ecuador's House in Order*, INSTITUTIONAL INVESTOR (INT.), Sept. 2000, at 11; O'Brien, *Queens*, *supra* note 56, at 24.

⁸¹ Gopinath, *supra* note 80, at 11.

⁸² See O'Brien, *Queens*, *supra* note 56, at 24 (discussing Ecuador's forced restructuring).

is worth what will turn out to be a paltry sum.

However, Ecuador's sovereign debt was a mere pittance compared to what Argentina has borrowed. For that reason, default by Argentina will have a much more significant effect on other Latin American nations, especially Brazil, with whom Argentina conducts trade.⁸³

Therefore, if the recent bond swaps fail to bring relief to Argentina's debt crisis in the next few months, Argentina should negotiate with its creditors in order to avoid a complete default. Argentina should try to strike a deal in which debtholders will agree to decrease the principal on the loans in exchange for a return to Brady bonds secured by United States Treasury bonds. Complete default on Argentina's sovereign debt will wreak havoc on the economies not only of other Latin American nations, but on Asia as well.⁸⁴ In order to maintain economic stability throughout the world, creditors and debtors must work together to find a solution. Ninety-seven percent of Ecuador's sovereign creditors agreed to restructure their holdings.⁸⁵ Perhaps Argentina's debtholders will be as willing to aid the country in its struggle for economic well-being.

5. RECENT JUDICIAL DECISIONS INVOLVING SOVEREIGN DEBT CREDITORS

Not all of the creditors of sovereign nations will necessarily choose to convert their holdings into Brady bonds. In the past few years, an increasing number of cases brought in federal courts of the United States involved creditors of Latin American nations seeking payment on their portions of the debt. These suits are often brought by either creditors who did not participate in Brady restructurings or by assignees of original creditors of the sovereign loans. Many of the suits are brought because each creditor is a holder of a relatively small segment of the debt, and "small debt makes the chance of recovery greater, since foreign nations are more likely to have some assets to attach in the U.S., though not enough to satisfy a large damage award."⁸⁶

⁸³ Helft, *supra* note 78 at *1; Roche, *supra* note 66, at 8; *Sovereign Debt Market*, *supra* note 66, at 12; Wheatley, *supra* note 66, at 78.

⁸⁴ See Roche, *supra* note 66, at 8 ("Even Asia would not be immune to a Latin American crisis.").

⁸⁵ Gopinath, *supra* note 80, at 11; O'Brien, *Queens*, *supra* note 56, at 25.

⁸⁶ Goldman, *supra* note 8, at 171.

It is possible that creditors refrain from engaging in Brady or other similar restructuring plans in the hopes that they will recover damages through the use of the court system. In other words, suits are brought because creditors believe that they have a greater chance of being paid than if they waited for the borrowers to make their scheduled payments. Analysis of these cases will show that this incentive has led to greater problems and less actual recovery than the creditors may have hoped. Therefore, it is necessary to devise a more equitable solution that will benefit not only the creditors, but the impoverished debtors as well.

5.1. *CIBC Bank & Trust Co. Ltd. v. Banco Central do Brasil*

The case of *CIBC Bank & Trust Co. Ltd. v. Banco Central do Brasil*,⁸⁷ decided in 1995, was a landmark case involving the alleged breach of contract of a sovereign debt restructuring agreement. The agreement at issue, the Multi-Year Deposit Facility Agreement ("MYDFA"), was signed in 1988 by the country of Brazil, its Central Bank, and many of the creditors holding Brazil's sovereign debt, in order to "restructure that debt, and to facilitate an orderly repayment of it, in the wake of Brazil's inability to make timely loan payments during the mid-1980s."⁸⁸ In 1989, the MYDFA was reworked and renegotiated under a Brady-type plan ("the 1992 Financing"), as Brazil was once again unable to make timely payments on its loans.⁸⁹ Under the 1992 Financing, creditors had the option of exchanging their MYDFA debt for new debt instruments.

Although a majority of the creditors agreed to go along with this conversion plan, two refused and held on to their debt pursuant to the terms of the MYDFA. The Dart family, beneficial owners of the plaintiff's portion of the debt, retained \$1.4 billion of MYDFA debt instead of converting it.⁹⁰ One of the defendants in the action, Banco do Brasil, also maintained \$1.6 billion in MYDFA debt following the 1992 Financing. According to the complaint, "Brazilian officials ordered [Banco do Brasil] to retain that amount of MYDFA debt in order to ensure that the Darts would not hold a

⁸⁷ *CIBC Bank & Trust Co. (Cayman) Ltd. v. Banco Central do Brasil*, 886 F. Supp. 1105 (S.D.N.Y. 1995).

⁸⁸ *Id.* at 1107.

⁸⁹ *Id.*

⁹⁰ *See id.* (explaining the background of Brazil's debt).

majority of the remaining MYDFA debt"⁹¹

In May 1994, Bankers Trust, Bear Stearns, and Salomon Brothers, who were the previous holders-of-record of the Dart family's portion of the MYDFA debt, assigned the debt to CIBC Bank and Trust Company (Cayman), Ltd. ("CIBC") to act on behalf of the Darts. CIBC then turned in an "Agreement to be Bound," but the Banco Central do Brasil ("Banco Central") refused to acknowledge the assignment, claiming that the debt had to be assigned to the Darts family itself.⁹²

In its complaint, CIBC brought eight claims against the Banco Central, the Banco do Brasil, and Citibank.⁹³ The court determined that the debt was properly assigned to CIBC and found that the relationship between the Dart family and CIBC was analogous to the relationship between the Dart family and its previous holders-of-record, Bankers Trust, Bear Stearns, and Salomon Brothers. It was noted, however, that unlike the relationship with CIBC, "those relationships were never challenged by the defendants."⁹⁴

The court also rejected the defendants' contention that the case should be dismissed because it violated the anti-champerty provisions of section 489 of the New York Judiciary Law.⁹⁵ Champerty is a practice "in which one person, the champertor, agrees to support another in bringing a legal action, in exchange for part of the proceeds of the litigation."⁹⁶ In this case, the defendants argued that the plaintiffs were assigned the Darts' MYDFA debt specifically for the purpose of bringing a lawsuit and recovering money from Brazil.⁹⁷ This addresses the heart of the reasoning behind the prohibition of champerty: that permitting champertous actions increases the filing of frivolous litigation and this, in turn, leads to

⁹¹ *Id.* The MYDFA allows for the potential acceleration of all MYDFA debt if Brazil defaults, so long as more than 50% of the creditors vote for acceleration. It was therefore important to Brazil that the Darts remained in control of less than 50% of the remaining MYDFA debt.

⁹² *See id.*

⁹³ *Id.* at 1108.

⁹⁴ *Id.* at 1110.

⁹⁵ *Id.* at 1110 n.5. According to "[s]ection 12.11, the MYDFA 'shall be governed by, and construed in accordance with, the laws of the State of New York, United States.'" *Id.*

⁹⁶ Susan Lorde Martin, *Financing Plaintiffs' Lawsuits: An Increasingly Popular (and Legal) Business*, 33 U. MICH. J.L. REFORM 57, 58 (1999).

⁹⁷ *See CIBC*, 886 F. Supp. at 1110.

increased damages.⁹⁸ The court found, however, that CIBC did not violate the New York champerty statute in filing this lawsuit. The defendants did not meet their burden of proving that the assignment of the MYDFA suit was made for the specific purpose of litigation.⁹⁹ This finding is important in analyzing the United States' policy regarding Latin American sovereign debt, as it is a very pro-creditor stance.¹⁰⁰

Although it denied the defendants relief on their defenses to the complaint, the court dismissed six of the eight claims brought by the plaintiff.¹⁰¹ The court did not dismiss the CIBC's claim that Banco Central breached the MYDFA in refusing to pay part of the interest due to CIBC's predecessors as holders of debt. Banco Central did not deny these allegations.¹⁰² In addition, the court allowed plaintiff's third claim, which asked for indemnification of the expenses incurred by CIBC as a result of the defendants' alleged breach of the MYDFA.¹⁰³

The court, however, dismissed the remainder of plaintiff's claims, pursuant to the motions filed by the defendants. The fourth claim in the complaint was the only one lodged against all three of the defendants. In this claim, CIBC contended that it had the power to accelerate the payment of the principal under the MYDFA.¹⁰⁴ Section 10.01(a) of the MYDFA defines the nonpayment of any amount of principal or interest as termination of the agreement. Under the provisions of this section, if the obligation is terminated, a simple majority of the holders of outstanding debt

⁹⁸ See generally Note, *The Effect of Champerty on Contractual Liability*, 79 LAW Q. REV. 493, 494 (1963) (explaining that the common law had long forbidden champertour agreements on the grounds that such agreements tended to inflame damages).

⁹⁹ See *CIBC*, 886 F. Supp. at 1111; see also *Fairchild Hiller Corp. v. McDonnell Douglas Corp.*, 270 N.E.2d 691, 693 (N.Y. 1971) ("[T]he question of intent and purpose of the purchaser or assignee of a claim is usually a factual one to be decided by the trier of facts . . .").

¹⁰⁰ See discussion *infra* Section 6 for a further analysis of the champertous motives of creditors.

¹⁰¹ See *CIBC*, 886 F. Supp. at 1120 (holding that Banco Central's motion to dismiss was granted in part and denied in part).

¹⁰² *Id.* at 1111.

¹⁰³ *Id.* at 1113 (finding that although CIBC failed to submit the required notice and an itemization of its expenses, it would have been futile for CIBC to do so and therefore refused to dismiss that count of the complaint).

¹⁰⁴ *Id.* at 1113.

can declare an acceleration of the principal.¹⁰⁵ The defendants argued that because Banco do Brasil owned more MYDFA debt than CIBC, CIBC did not have the authority to unilaterally declare an acceleration, and that because Banco do Brasil refused to consent to an acceleration, CIBC was precluded from doing so.¹⁰⁶ The plaintiff argued that the Banco do Brasil's share of the MYDFA should not be counted because it was retained "in a bad faith maneuver designed to block CIBC's acceleration attempt."¹⁰⁷ Although the plaintiff pointed to four sources of law to bolster its position,¹⁰⁸ the court found these justifications to be completely unfounded. In dismissing this claim, the court announced that "it is clear that the provisions of the MYDFA expressly allow [Banco do Brasil] to retain MYDFA debt and to vote its share of that debt in order to hinder an attempt at acceleration by another creditor."¹⁰⁹

The case was subsequently settled. Brazil agreed to pay the Dart family \$25 million in cash and \$52.3 million in bonds.¹¹⁰

5.2. *LNC Investments, Inc. v. Republic of Nicaragua*

The case of *LNC Investments, Inc. v. Republic of Nicaragua*¹¹¹ was brought in federal court in the Southern District of New York, and decided in February, 1999. At issue in the case was the defendant's failure to pay the money owed to the plaintiff in the form of debt obligations. The plaintiff, LNC Investments ("LNC"), a wholly owned subsidiary of Leucadia National Corporation ("Leucadia"), owned debt and equity securities on Leucadia's behalf.¹¹²

On December 11, 1980, Nicaragua entered into a restructuring agreement ("1980 Loan Agreement"), which specified terms by which it was to repay its sovereign debt ("Category I Debt").¹¹³

¹⁰⁵ *Id.* (citing MYDFA § 10.01, ¶¶ X-7, X-8).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 1114.

¹⁰⁸ The plaintiff argued that the New York common law of compositions, the federal Bankruptcy Code, the federal Trust Indenture Act of 1939, and the New York Business Corporation Law supported its proposition that Banco do Brasil's holdings should have been excluded because of bad faith. *See id.*

¹⁰⁹ *Id.* at 1116.

¹¹⁰ Power, *supra* note 2, at 2750-2751.

¹¹¹ *LNC Inv., Inc. v. Republic of Nicar.*, No. 96 Civ. 6360, 1999 U.S. Dist. LEXIS 1846, at *1 (S.D.N.Y. Feb. 19, 1999).

¹¹² *Id.* at *1-2.

¹¹³ *See id.* at *3-4 (listing some of the terms of the 1980 Loan Agreement).

The principal amount of the Category I Debt was divided into three installments, called Tranche¹¹⁴ A, Tranche B, and Tranche C loans. The 1980 Loan Agreement also listed dates by which Nicaragua was required to pay back certain amounts.¹¹⁵ When Nicaragua failed to meet the payment schedule in the 1980 Loan Agreement, a letter, called the First Letter Agreement (dated February 9, 1984), was written to amend the original Agreement.¹¹⁶ Since Nicaragua was also unable to meet the payment schedule in the First Letter Agreement, it was further amended in the Second Letter Agreement, which was signed shortly over a year later (on June 17, 1985).¹¹⁷ Nicaragua also was unable to make its payments under the Second Letter Agreement.

On October 3, 1986, LNC purchased by assignment over \$18 million in Category I Debt, including the accrued interest, from Drexel Burnham Lambert, Inc. ("Drexel") for just over \$896,000.¹¹⁸ In August 1987, LNC purchased another \$7,783,028.19 of debt by assignment from National Westminster Bank USA ("National Westminster").¹¹⁹

The Bank of America was the servicing bank for Nicaragua's Category I Debt. It listed LNC as the record owner of \$26,252,287.40 of Category I Debt. Nicaragua also had notice that LNC was the record owner of this portion of debt.¹²⁰ Under the 1980 Loan Agreement, Nicaragua issued promissory notes to all record owners of Category I Debt.¹²¹ Although National Westminster gave promissory notes to LNC following the assignment of its debt, Drexel failed to do the same despite its promise.¹²² In 1990, Drexel filed for bankruptcy. In 1996, the United States Bankruptcy Court for the Southern District of New York authorized Drexel's successor to destroy all files held in storage. This included all but one of the promissory notes that should have been delivered to LNC under the assignment agreement.¹²³ Therefore, the promis-

¹¹⁴ A tranche is an installment of a loan.

¹¹⁵ *LNC Inv., Inc.*, 1999 U.S. Dist. LEXIS 1846, at *3.

¹¹⁶ *Id.* at *4-5.

¹¹⁷ *Id.* at *5.

¹¹⁸ *See id.* at *7 (describing LNC's purchase of debt from Drexel).

¹¹⁹ *Id.*

¹²⁰ *See id.* at *8.

¹²¹ *Id.* at *10.

¹²² *See id.* at *10-11.

¹²³ *See id.* at *11-12.

sory notes that LNC received from Drexel only accounted for \$2,327,535.84 of the Category I Debt that Drexel assigned to LNC.¹²⁴

Nicaragua offered to purchase its Category I Debt from the record owners for eight percent of the amount of the outstanding principal in September 1995.¹²⁵ Record owners choosing to sell their debt back to Nicaragua were not required to show their promissory notes, but if they accepted the debt purchase offer, they were required to destroy any promissory notes that they had for Category I Debt.¹²⁶ Eighty percent of the record owners of Category I Debt accepted the debt purchase offer and sold their holdings back to Nicaragua.¹²⁷ LNC decided not to participate in the debt purchase offer and retained its Category I holdings of \$26,252,287.40.¹²⁸ Instead, LNC demanded that Nicaragua pay LNC the full amount of its portion of the debt. Nicaragua refused and LNC filed suit seeking to recover that money.¹²⁹

Nicaragua argued that section 10.11 of the 1980 Loan Agreement only allowed assignment of debt to financial institutions and banks, and that LNC did not qualify as either. It therefore contended that the assignment of Category I Debt to LNC was improper and, for that reason, unenforceable.¹³⁰ In rejecting Nicaragua's argument, the court relied on another Latin American sovereign debt case, *Pravin Banker Associates, Ltd. v. Banco Popular del Peru*.¹³¹ In *Pravin*, the Second Circuit found that under New York law, "[t]o reveal the intent necessary to preclude the power to assign, or cause an assignment violative of contractual provisions to be wholly void, [a contractual] clause must contain express provisions that any assignment shall be void or invalid if not made in a certain specified way."¹³² The language in LNC specifically allowed assignment to banks and financial institutions, but it did not

¹²⁴ *Id.* at *11.

¹²⁵ *Id.* at *12.

¹²⁶ *Id.* at *12-13 (describing Nicaragua's Debt Purchase Offer).

¹²⁷ *Id.* at *13.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at *15-16.

¹³¹ *Pravin Banker Assocs., Ltd. v. Banco Popular del Peru*, 109 F.3d 850 (2d Cir. 1997).

¹³² *Id.* at 856 (quoting *University Mews Assocs. v. Jeanmarie*, 471 N.Y.S.2d 457, 461 (N.Y. Sup. Ct. 1983)).

expressly preclude assignment to any other parties.¹³³ The court therefore determined that the assignments of Category I Debt to LNC by Drexel and National Westminster were valid.¹³⁴

In its second argument, Nicaragua contended that LNC would only be able to recover the portion of the debt for which it possessed promissory notes.¹³⁵ The court found, however, that section 2.13(e) of the 1980 Loan Agreement provided that if a promissory note is lost or destroyed, the amount of debt held by a record owner shall be deemed to be the amount listed by the servicing bank.¹³⁶ The promissory notes that LNC should have received from Drexel were destroyed pursuant to the order of the Bankruptcy Court. The court determined that the account maintained by the Bank of America, the servicing bank, was sufficient to prove the amount owed to LNC.¹³⁷

The court granted summary judgment for the plaintiff, LNC Investments, in the amount of \$26,252,287.40.¹³⁸

5.3. *Elliott Associates, L.P. v. Banco de la Nación*

Most recently, the Second Circuit decided *Elliott Associates, L.P. v. Banco de la Nación*.¹³⁹ This case was brought on appeal from the Southern District of New York, from a judgment dismissing the plaintiff's complaint because the court "found that Elliott had purchased the debt in violation of section 489 of the New York Judiciary Law."¹⁴⁰

Elliott Associates ("Elliott") is an investment fund that primarily invests in the securities of debtors who have defaulted on their

¹³³ *LNC Inv.*, 1999 U.S. Dist. LEXIS 1846, at *6-7 (quoting section 10.11 of the 1980 Loan Agreement).

¹³⁴ *Id.* at *17-18.

¹³⁵ *See id.* at *18 (revealing the basis of Nicaragua's argument as section 2.13(e) of the 1980 Loan Agreement).

¹³⁶ *Id.* at *18.

¹³⁷ *Id.* at *20-21 ("The records maintained by both the Bank of America and by LNC indicate that LNC owned \$26,252,287.40 of Nicaragua's Category I Debt, excluding interest accrued after June 1986.").

¹³⁸ *Id.* at *21.

¹³⁹ *Elliott Assocs. v. Banco de la Nación*, 194 F.3d 363 (2d Cir. 1999).

¹⁴⁰ *Id.* at 365; *see also Elliott Assocs. v. Republic of Peru*, 12 F. Supp. 2d 328 (S.D.N.Y. 1998) (holding that New York's champerty statute prohibited the purchase of sovereign debt with the intent to sue under the circumstances of the case).

payment obligations.¹⁴¹ In October 1995, Elliott purchased approximately \$28.75 million of Panamanian sovereign debt, and brought suit against Panama in July 1996 for full payment of that debt. As a result of that suit, Elliott received over \$57 million.¹⁴²

During the first three months of 1996, Elliott acquired the debt at issue in this suit. It purchased by assignment a total of \$20.7 million in principal of Peruvian working capital debt¹⁴³ from ING Bank, N.V. ("ING") and Swiss Bank Corporation ("Swiss Bank").¹⁴⁴ In May 1996, Elliott notified Banco de la Nación ("Nación") and the Republic of Peru ("Peru") that it was interested in starting up negotiations about the repayment of Elliott's debt holdings, but negotiations never took place.¹⁴⁵ Nación and Peru refused to engage in any deals with Elliott because they regarded the debt assignments as invalid since Elliott was not a financial institution.¹⁴⁶ Near the end of June 1996, Elliott sent Nación and Peru a notice of default. When the debtors refused to pay, Elliott filed suit in the New York Supreme Court for an ex parte order of prejudgment attachment.¹⁴⁷ The suit was removed to federal district court under the Foreign Sovereign Immunities Act.¹⁴⁸ Elliott's motion for prejudgment attachment was denied, as well as its motion for summary judgment.¹⁴⁹ After a bench trial, the district court found that Elliott had "purchased the Peruvian debt with the intent and purpose to sue" and "did not seriously consider alternatives to bringing an action."¹⁵⁰ For this reason, the district court ruled that Elliott's contracts were unenforceable because they were entered into with champertous intent in violation of New York law.¹⁵¹

In its discussion, the Second Circuit focused on interpreting

¹⁴¹ *Elliott Assocs.*, 194 F.3d at 365.

¹⁴² *Id.* at 366.

¹⁴³ Working capital debt "consists of direct loans between single lenders and borrowers, whereas syndicated bank debt is debt syndicated by a lead bank, which maintains books and records for all holders." *Id.* at 367.

¹⁴⁴ *Id.* at 366-67 (detailing the assignments from ING and Swiss Bank).

¹⁴⁵ *Id.* at 367.

¹⁴⁶ *See id.*; *see also Pravin Banker Assocs.*, 109 F.3d at 856 (noting the claim that factual issues exist regarding Pravin's status as a financial institution).

¹⁴⁷ *Elliott Assocs.*, 194 F.3d at 368.

¹⁴⁸ 28 U.S.C. § 1441(d) (1994).

¹⁴⁹ *Elliott Assocs.*, 194 F.3d at 368.

¹⁵⁰ *Elliott Assocs.*, 12 F. Supp. 2d at 332, 338.

¹⁵¹ *See id.* at 356 (elaborating on Elliott's violations of section 489 of the New York Judiciary Law).

section 489 of the New York Judiciary Law. It found that "the acquisition of a debt with intent to bring suit against the debtor is not a violation of the statute where, as here, the primary purpose of the suit is the collection of the debt acquired."¹⁵² The court cited extensively from a New York Court of Appeals case, *Moses v. McDivitt*, in reaching its decision.¹⁵³ According to the *Moses* court, "[t]o constitute the offense the primary purpose of the purchase must be to enable him to bring a suit, and the intent to bring a suit must not be merely incidental and contingent."¹⁵⁴

Using *Moses* and subsequent cases, the Second Circuit found that Elliott's intention to bring suit against Nación and the Republic of Peru was secondary to its intention to be paid in full for the debt that it purchased.¹⁵⁵ Additionally, because Elliott had attempted to negotiate terms of repayment with the debtors, Elliott's intention to file suit was contingent upon the debtors' refusal to negotiate or to repay the debt at Elliott's request.¹⁵⁶ The court therefore held that Elliott had not violated the New York Judiciary Law and that the district court had, in fact, misinterpreted section 489.¹⁵⁷

Pursuant to these findings, the Second Circuit reversed and remanded for further proceedings.¹⁵⁸ Subsequently, judgment was ordered in favor of Elliott Associates. Nación was ordered to pay \$24,725,391.41 and Peru was ordered to pay \$55,660,831.56, for principal and past due interest.¹⁵⁹

6. ANALYSIS OF RECENT CASE LAW

Each of the three cases described above has had a major impact on the way sovereign debt, and its creditors, are treated in the United States. Although the United States submitted a statement of interest on behalf of the defendants in *CIBC Bank*, it seems fairly clear that the United States' interests generally lie with the credi-

¹⁵² *Elliott Assocs.*, 194 F.3d at 372.

¹⁵³ *Moses v. McDivitt*, 88 N.Y. 63 (1882).

¹⁵⁴ *Id.* at 65.

¹⁵⁵ *Elliott Assocs.*, 194 F.3d at 379.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 381.

¹⁵⁸ *Id.*

¹⁵⁹ *Elliott Associates, L.P. v. Banco de la Nación*, 96 Civ. 7916, 2000 U.S. Dist. LEXIS 14169, at *2 (S.D.N.Y. Sept. 29, 2000).

tors.

The *Elliott Associates* court spent quite a bit of time setting forth its policy reasons for overturning the district court's decision.¹⁶⁰ Although the United States is a strong proponent of the Brady Plan, the goal of the United States is to entice creditors to participate voluntarily. Therefore, if creditors were barred from recovering debts owed to them in court, they would effectively be forced either to accept some form of debt restructuring or to lose all hope of ever seeing a return on their investments.¹⁶¹ This would, the argument concludes, cause the progress made by the Brady Plan to collapse. Because the plan was designed to be voluntary, it would be completely undermined were creditors prevented from bringing suit on the debt. For this reason, federal courts in the United States permit suits by sovereign debt creditors, and allow for large, and sometimes full, recoveries.

Another policy reason put forth by the *Elliott* court involves a seemingly pro-Latin American perspective. The court reasoned that in order for investors to continue lending money to Latin American nations, as well as to other markets, there needs to be a means of enforcing debt contracts. Otherwise, there will be no investment, which causes serious repercussions for further investment in Latin American countries. Without a means of enforcing sovereign debt obligations, the next time a Latin American government is in need of money, it will find no willing investors. In essence, this argument suggests that the use of litigation as an enforcement mechanism benefits those nations in need of financial assistance.

However, while many understandably accept the validity of these arguments, it appears that the United States is forgetting a very important point—if the Latin American sovereigns had the money to pay their debts, they would have done so. Additionally, some creditors may refuse to participate in a Brady Plan or other type of debt restructuring scheme because they believe that there is a possibility of a greater recovery through litigation. *Elliott Associates* “frequently engages in direct negotiations with the debtor and argues that, as a result, it has occasionally received a greater

¹⁶⁰ See generally *Elliott Assocs.*, 194 F.3d at 379-81 (outlining the competing policy interests at issue in sovereign debt cases).

¹⁶¹ See *id.* at 379-80 (citing *Pravin Banker Assocs., Ltd. v. Banco Popular del Peru*, 109 F.3d 850 (2d Cir. 1997)).

return than other creditors.”¹⁶² Elliott’s use of the court system is a means of inducing its debtors to negotiate.

In both *CIBC Bank* and *Elliott Associates*, the courts found that the plaintiffs did not violate the anti-champerty statute, section 489 of the New York Judiciary Law, because they purchased the debt with the intent to recover the debt owed and not with the specific intent to litigate.¹⁶³ This conclusion fits in conveniently with the pro-creditor policy of the United States. Although the recovery of debt is not considered a champertous motive and participation in a restructuring program is voluntary, the creditor-plaintiffs must have known that litigation would have been the only other way to recover their portion of the debt when they purchased it. In some cases, the primary motive for purchasing Latin American debt was for the creditors to recoup their money through litigation. The Brady Plan restructurings assisted in the stabilization of the Latin American debt market and enabled the possibility of some recovery by creditors at a future date. However, the creditors who brought suit in federal courts were apparently too greedy to wait.

In all three of the above cases, the plaintiffs received millions of dollars in judgment or settlement. This was even the case in *CIBC Bank*, in which the court decided that it was possible for a sovereign debtor to retain a majority interest in its own debt and thereby block other creditors from causing an acceleration of payment. This seemed to be a major step in favor of the Latin American debtors because it allowed them to subvert, to some extent, the ability of other creditors to recoup their debt payments at the expense of a nation that was not fiscally ready to pay them. However, the case settled and the plaintiff received millions of dollars in spite of its inability to accelerate the debt payment on its own.

CIBC Bank, *LNC Investments*, and *Elliott Associates* are not the only three cases decided in favor of creditors of sovereign debtors. Instead, these three cases were chosen for analysis because they each deal with a different debtor nation within Latin America. It appears that the policy of the United States towards sovereign debtors, irrespective of which nation they represent, is to allow creditors to recover at their own expense, through the use of the federal court system.

¹⁶² *Elliott Assocs.*, 194 F.3d at 365.

¹⁶³ *CIBC Bank*, 886 F. Supp. at 111; *Elliott Assocs.*, 194 F.3d at 378-379.

7. ANALYSIS OF PROPOSED SOLUTIONS

The result of litigation by sovereign debt creditors leaves debtor nations in the position of paying judgments with money that they do not have. Instead of allowing debtor nations time to settle their fragile economies, these nations are left in worse positions than before. Therefore, solutions must be devised to permit Latin American governments to achieve stability while satisfying their creditors. While various commentators have proposed numerous solutions to this problem,¹⁶⁴ two are the most viable: the use of exit consents and the placement of a limit on recovery in a lawsuit.

7.1. *Exit Consents*

Many sovereign bond agreements contain clauses that permit a specified percentage of the creditors to amend the terms of the bond, except for the amount and due dates of the payments.¹⁶⁵ Exit consents create new bond agreements with terms more favorable to the debtors and allow creditors to voluntarily exchange their old agreements for the new ones. However, because many creditors would be wont to relinquish their old bonds (hoping to get paid earlier), it is necessary for those creditors switching to the new agreement to amend the terms of the old agreement to make the older terms less amenable to the remaining "holdout" creditors.¹⁶⁶ The exit consents allow sovereign debtors to restructure their debt agreements and to induce creditors who would otherwise not agree to a restructuring by adding provisions that make the new, restructured agreement more attractive. This new agreement is also more favorable to borrower nations, as it "reflect[s] the borrower's anticipated future debt-servicing capacity"¹⁶⁷ without forcing them to pay back exorbitant amounts of debt before first acquiring the finances to do so.

In the absence of exit consents, it is normally more advanta-

¹⁶⁴ See, e.g., BARRY EICHENGREEN, TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE 65-67 (1999) (favoring changes to international lending contracts to allow debtors to renegotiate); Kenneth Rogoff, *International Institutions for Reducing Global Financial Instability*, J. ECON. PERSP., Fall 1999, at 21, 30 (discussing proposals for an international bankruptcy court).

¹⁶⁵ Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 66 (2000).

¹⁶⁶ See *id.*

¹⁶⁷ *Id.*

geous for creditors to hold on to their old agreements. A majority of holdout creditors are able to force an acceleration of the payments¹⁶⁸ and, almost inevitably, cause the debtor to default. This enables creditors to sue in federal court in the United States and, given current case law in this area, recover a substantial portion, if not all, of the money owed. If the sovereign did not default, the creditors still receive their money. Either of these eventualities are be detrimental to the economic health of the Latin American government in question.

The use of exit consents to render the old bond agreements less attractive therefore helps solve the problem of huge federal court judgments in favor of holdout creditors. It also gives sovereign debtors more time to stabilize their economies before having to pay back debts with money that they do not have, which either forces them to take out new loans, creating a vicious cycle, or leads to the total collapse of their already fragile economic systems.

7.2. *Limits on Recovery in Lawsuits*

Samuel Goldman proposed placing a ceiling on the amount of money that can be recovered by a creditor of a sovereign nation in a lawsuit.¹⁶⁹ This limit could either be calculated as a percentage of the total debt of a nation, thus allowing each creditor a pro rata share, or it could be a set number, permitting the creditor who gets to court first to collect the entire amount.¹⁷⁰ There are several beliefs behind the institution of a limited recovery system. Investors might be more likely to purchase smaller pieces of debt, rather than larger ones, knowing they would lose money in the event of default because they would be unable to litigate for the full amount.¹⁷¹ In addition, this provides an incentive for debtor nations to be more responsible instead of partaking in riskier ventures because there is a greater chance that the country will have to pay out smaller amounts of debt rather than larger portions. Thus, borrowers will not have to risk the possibility of a bigger payoff in order to pay off creditors.¹⁷² If investors find that they are able to recover money through lawsuits, they might be more interested in

¹⁶⁸ *Id.*

¹⁶⁹ Goldman, *supra* note 8, 176-84.

¹⁷⁰ *See id.* at 176-77.

¹⁷¹ *Id.* at 178.

¹⁷² *See id.* at 179-80.

purchasing debt, leading to a more liquid and efficient market.¹⁷³

7.3. *Further Analysis of Proposed Solutions*

Each of the above solutions would provide a cushion for Latin American debtors by allowing them either more time or less of a burden in paying off their debts. A combination of these two proposals would be even more effective.

Exit consents are intended to persuade creditors to accept new bond agreements with more relaxed payment provisions. Potential holdout creditors, ideally, choose to exchange their old bond agreements, now with less favorable terms for debtholders, for new bond agreements that are more attractive to both creditors and debtors. The more creditors that accept the new agreements, the fewer holdouts there are to force accelerations of payment and thereby cause default. This would in turn lead to less litigation and, hopefully, more money to be used by Latin American debtors in rebuilding their infrastructures.

Placing a limit on recovery in lawsuits also leads to the availability and recirculation of more money in borrower nations because payouts would be smaller. However, this does not necessarily reduce the number of lawsuits being brought. Because each creditor is interested in owning a smaller piece of debt, there are more investors, each with a claim that could be brought in federal court. This is especially true if the limitation placed enables each creditor to receive his or her pro rata share of the total debt. While individual recoveries would not be as large as they are now, there would be tremendous litigation costs for the borrowers. There are no incentives for creditors to refrain from bringing suit, especially since they have the potential to get some money back.

Therefore, the best solution is to structure the exit consents to amend the old bond agreements to limit the amount of money that can be recovered in a lawsuit, or to limit the number of lawsuits that can be brought by creditors. This induces more potential holdouts to exchange their old debt for new debt and thereby reduces the number of lawsuits brought. If debtholders had the choice of either litigating and recovering only a portion of their money or switching to a new agreement and waiting only a few more years for the possibility of a full return, many would be swayed to accept the new terms. Thus, while it will take longer for

¹⁷³ *Id.* at 180.

the creditors to get back their investments, they will get back one-hundred percent of that which they loaned to the sovereigns instead of holding out for a chance at a small percentage of the loan through litigation. As for the borrowers, they will have more time to rebuild their economies before having to pay back the principal on their debt, thereby creating a less-pressured situation for them. There will be a smaller chance of litigation and, regarding suits that are brought, borrowers will have to deal with much smaller payouts.

It can be argued that the use of exit consents is manipulative and that by including a provision limiting or precluding the ability to bring suit, creditors are being unfairly deprived of a means of recovering their investment. However, the creditors retain a choice. Exchanging old bond agreements for new ones would be done on a purely voluntary basis. Although the exchange option is likely to be more advantageous after the old agreements are amended, creditors would not be forced to accept the new terms.

Therefore, exit consents should be used to amend bond agreements in order to restrict or limit recovery in lawsuits by sovereign debt creditors. This solution would be advantageous to all involved and will lead to greater stability in Latin America.

8. CONCLUSION

Throughout the past two decades, Latin American nations have been struggling to keep up with debt obligation payments while still trying to prevent the total collapse of their economies. While several countries have been able to exchange some of their Brady bonds for their own more stable, uncollateralized bonds, signifying the return of economic health, others have not been so fortunate. Argentina, which owes almost \$130 billion in sovereign debt, is on the verge of default. The government and its creditors need to collaborate in order to prevent this disaster, which is otherwise inevitable.

This hope of collaboration is complicated, however, by the possibility that debtholders, instead of working to reach the goal of economic health for Argentina, would choose to bring suit against the impoverished nation. Recent litigation in other Latin American nations has resulted in huge payments to creditors who have refused to participate in the restructuring programs that are the borrowers' best hopes of getting back onto their feet. These judgments have led to, and will continue to lead to, the further weakening of

the debtor states unless something is done. The use of exit consent amendments limiting or precluding recovery through lawsuits may be the solution that will both satisfy creditors and permit Latin America to rebuild itself.